Commonwealth Grants Commission 2025 Review

Fiscal equalisation, supporting principles and assessment guidelines

Submission by the South Australian Department of Treasury and Finance

May 2023

Government of South Australia
Department of Treasury and Finance

CGC 2025 Review – SA submission in response to *fiscal equalisation, supporting principles and assessment guidelines consultation paper*

Horizontal Fiscal Equalisation

Question 1

Does the approach to horizontal fiscal equalisation articulated in the 2020 Review remain the appropriate first step in determining GST distribution in accordance with the GST distribution legislation?

South Australia has always supported and strongly advocated for GST revenue being distributed based on a methodology that seeks to achieve full horizontal fiscal equalisation (HFE) to the greatest extent possible.

Full HFE seeks to ensure that all Australians, regardless of what state or territory (state) they live in can have access to services and infrastructure of the same standard.

The 2018 legislative changes were a move away from full equalisation which diminishes the extent of equalisation. However, the legislated changes use a full equalisation base from which adjustments are made to arrive at a final distribution that incorporates equalisation to the fiscally stronger of New South Wales or Victoria and a distribution floor. Full HFE is also relevant for the calculation of no worse off relativities.

South Australia believes that the objective of HFE articulated in the 2020 Review remains appropriate as a first step in determining GST distributions, namely that relative fiscal capacities are determined such that:

> *after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure to the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.*

The Commission's interpretation of HFE and how it should be applied does not need to be altered.

Supporting principles

The Commission regards one of its core responsibilities as identifying influences, also known as 'drivers', that are beyond the direct control of states that cause fiscal capacities to diverge between states. To apply the HFE principle, the Commission has developed four supporting principles, including 'what States do', policy neutrality, practicality, and contemporaneity, to direct the design and evaluation of assessment methods. These supporting principles are not prioritised in any particular order.

South Australia believes the current supporting principles remain appropriate and should be retained for the 2025 Review.

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What states do

> **<u>Question 2</u>**
>
> *Does the 'what states do' principle, with assessments based on the weighted average policy of all states, remain appropriate?*

The 'what states do' principle is necessary in determining the scope of equalisation. Equalisation should take into account all roles and functions of state governments and how these are delivered.

Current HFE assessments are based on the average policy of what states actually do, rather than attempting to make judgements on what states could or should do. This is appropriate, and if the scope of expenditures or revenue change over time, this will be reflected in the assessment where it has a material impact on fiscal capacities.

South Australia supports the 'weighted average policy' approach, recognising that in a few isolated cases there can be challenges where the weighted average is dominated by a large State. Nonetheless, no other superior approach is evident. The CGC should not attempt to assess what states should do.

Policy neutrality

> **<u>Question 3</u>**
>
> *Does the policy neutrality principle remain appropriate, recognising there are particular circumstances where further consideration should be given to policy neutrality, such as dominant state issues and some instances of state tax reform?*

The policy neutrality principle aims to ensure that the equalisation process creates no incentives or disincentives for states to choose one policy over another, and that no state can directly influence its GST share through its revenue or expenditure policy choices.

This is appropriate and the principle should be maintained.

Given the CGC's adoption of a weighted average policy approach, policy neutrality is not a concern in the majority of assessment areas.

It is acknowledged that concerns around policy neutrality can arise when a state generates significantly more revenue than its population share of a specific revenue source (eg mining revenues (Western Australia)) or accounts for significantly more than its population share of an expenditure category (eg Indigenous expenditure (Northern Territory)). Concerns about policy neutrality have also been raised when states impose restrictions on certain activities (eg a ban on certain mining activity) or implement tax policy changes.

While that is the case, there is no evidence that the current approach to HFE distorts government decision making in an efficiency-detracting way.

The Commission has stated that these particular issues will be considered further under the review of the mining assessment and consideration of the flexibility to changes in methods between reviews. South Australia will respond in detail as part of these processes.

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Practicality

Question 4
Does the practicality principle remain appropriate for ensuring assessment methods are simple, reliable and fit for purpose?

South Australia supports the Commission using the most reliable, fit-for-purpose data in its assessments.

Assessments should be derived in a simple and practical way, based on reliable data that is fit-for-purpose and consistent with achieving horizontal fiscal equalisation.

South Australia believes the Commission should maintain the adoption of the overall principle of practicality, recognising that there is a trade-off between simplicity, data reliability, and fitness for purpose when the CGC applies the principle. When facing new data issues, the Commission should consult with states during the review process and exercise its judgement to deliver an outcome most closely aligned with the achievement of HFE.

Contemporaneity

Question 5
Does the 3-year lagged average approach continue to provide the best balance between contemporaneity, predictability and stability in measuring states' fiscal capacities?

South Australia considers that the current three-year lagged average approach provides an appropriate balance between contemporaneity, predictability and stability in measuring states' fiscal capacities and determining GST shares. As has been noted in previous reviews, a shorter assessment period would increase between year volatility and South Australia is not convinced that this would necessarily lead to an improved HFE outcome.

The trade-offs involved in adopting either a shorter or longer assessment period have been the subject of detailed consideration in past methodology reviews. From a budget management perspective, the key benefit of a three-year lagged average is the stability it provides through the use of actual revenue and expenditure data and the use of three years' worth of data to smooth the effects of large one-off revenue or expenditure shocks.

The three-year lagged average assists states to anticipate changes in their GST relativities over time, even in situations where fiscal capacities change rapidly (for example after methodology reviews, significant data revisions, or large fluctuations in activity). While it is recognised that this may result in a less contemporaneous outcome in a single year, HFE is achieved over time with a lag. Given the sizeable contribution of GST revenue as a proportion of total revenue, particularly for smaller jurisdictions[1], this predictability is important from a fiscal management perspective and allows time for states' budgets to adjust to any significant shift in capacity.

[1] For example, GST revenue accounts for around 30 per cent of total general government revenue in South Australia.

Preliminary view on the supporting principles

Question 6

Do states agree that there is no need to introduce new principles?

South Australia supports the current supporting principles as they have provided a stable reference point for developing and updating the Commission's assessments over time. Any proposal to introduce new principles must be supported by robust evidence that there is a key aspect of HFE that is not currently addressed by the existing principles and cannot be addressed through adjustments to the existing principles.

The current supporting principles are the subject of the recent *Principles of Horizontal Fiscal Equalisation* occasional paper prepared by the Western Australian Treasury (the WA paper). South Australia notes that many of the issues raised in the paper have been considered in detail in past methodology reviews. In addition, we note that while the 2018 GST reforms have been specifically excluded from the scope of the WA paper, it could be argued that sustained criticism of HFE – particularly the operation of the contemporaneity supporting principle – is one of the main reasons for the 2018 reforms. It is important that this link is not ignored.

The WA paper proposes a new "policy consistency" supporting principle, which would be defined as:

> *"The CGC should calculate revenue bases and disability factors that reflect, as far as practicable, the same policies across states (taking into account all policies that could affect the size of these bases and factors)."*

Western Australia notes that this is different from policy neutrality, which it considers is more related to minimising the interaction of a state's policies and its GST share. To support discussion of this proposal, it may be helpful for Western Australia to provide practical examples of this distinction. For example, it could be argued that the Commission's current approach to assessing mining revenue:

- achieves policy consistency as revenue bases are calculated on the basis of the value of mineral production, despite not all states determining their revenue bases this way (e.g. the Northern Territory[2]). In other words, the assessments reflect the revenue base that would be available to each state under a uniform or consistent policy approach; and
- achieves policy neutrality by assessing revenue raising capacity on the basis of an "all-state" effective tax rate, reducing the extent to which an individual state may directly influence its GST share (with the obvious exception of iron ore revenue).

Notwithstanding this, South Australia notes that the WA paper does acknowledge that achieving the proposed definition of policy consistency would be very difficult in practice and notes that aggregated or global revenue base measures could be an alternative way to reflect the underlying capacity to pay. Again, the merits of these approaches have been considered in detail in previous methodology reviews and we do not consider that

[2] The Northern Territory operates a profit-based system, where royalties are calculated based on the net value of mining activities after deductions for eligible operating, capital and exploration costs (see https://treasury.nt.gov.au/dtf/territory-revenue-office/royalties/mineral-royalty).

there have been any significant changes since then to warrant revisiting this issue in the 2025 Review.

The WA paper also raises the potential for a “conservatism” principle, which would be defined as:

> *“In the face of uncertainty, the CGC should err on the side of a smaller GST redistribution through discounts towards equal per capita.”*

South Australia considers that the Commission’s current discounting framework is appropriate and supports the consistent application of discounts in assessments where the Commission has concerns about data or methods. We do not support proposals to apply discounts to the GST relativities of all or some states as considered in the WA paper. South Australia is not convinced that this approach, with the significant additional judgement it would entail, would produce a better HFE outcome than the current approach.

South Australia’s position on discounting more broadly is discussed further in the response to Question 9 below.

Assessment guidelines

Question 7

Do the assessment guidelines, and the Commission’s application of those guidelines, remain appropriate?

South Australia considers that the assessment guidelines articulated in the 2020 Review remain appropriate, noting that materiality thresholds are being revisited in the 2025 Review.

Materiality thresholds

Question 8

Should the materiality thresholds be increased broadly in line with state spending per capita (to $45 per capita for assessment of a driver and $15 per capita for a data adjustment)?

South Australia agrees that materiality thresholds should be revisited in the 2025 Review and adjusted as needed to maintain their value in real terms over time. This will retain the simplification gains achieved in previous methodology reviews. South Australia does not consider that there have been any changes since the 2020 Review that would warrant a real increase in the value of materiality thresholds.

The Commission has considered indexing the 2020 Review materiality thresholds based on nominal growth in either state government spending per capita or the prices faced by state governments (as measured by the State and Local Government Final Consumption Expenditure chain price index) since the 2020 Review.

Maintaining impacts in real terms involves adjusting for prices, not volume. On this basis South Australia supports indexing the materiality thresholds by prices faced by state governments. This is also consistent with the approach adopted in the 2020 Review. On the basis of information provided by the Commission in the discussion paper this would result in an increase in the materiality threshold to around $40 per capita for assessment of a driver and $12.50 for a data adjustment.

Discounting assessments

Question 9

Does the 2020 Review approach to discounting remain appropriate?

South Australia is comfortable with the current discounting framework, which includes a fixed set of discounting levels available for use where the Commission considers there are concerns about the reliability of data or a method.

However, in South Australia’s view, the specific level of discount applied in some instances is not always reflective of the level of concern about data or method reliability.

For example, South Australia has a longstanding concern that the 12.5 per cent discount applied to the wage costs assessment is not an adequate reflection of the range of data reliability issues in this assessment. South Australia’s views on this issue have been detailed in our submissions to previous methodology reviews.

Since the 2020 Review, additional data reliability concerns have emerged, primarily due to the impact of the COVID-19 pandemic on interstate private and public sector wage differentials. In the absence of reforms to the assessment as part to the 2025 Review process, this would lend support for a higher discount to reflect the additional data issues that have emerged since 2020. We trust this issue will be considered in detail as part of the upcoming consultations on individual assessments.

It is noted that following the review of all individual assessments as part of the 2025 Review, a review of the consistency of discounting between assessments would be appropriate.